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E.O. 12958: N/A
TAGS: ECON EFIN
SUBJECT: BRAZIL - THE ECONOMICS OF A POLITICAL CRISIS

REF: A) BRASILIA 1456
B) BRASILIA 521
C) BRASILIA 1631
D) BRASILIA 1290
E) BRASILIA 682
F) BRASILIA 1662

¶1. (SBU) Summary: Rattled by a mounting scandal over alleged Lula administration vote-buying in the Congress, the GoB has, among other measures, attempted to shore up support among the economic elite by enacting a decree to remove certain taxes on capital investments by exporters. The scandal has toppled Lula's powerful Chief of Staff (ref C) and will likely hasten the planned departure of Central Bank President Henrique Meirelles, currently under investigation on unrelated tax charges (ref D). Financial markets have hardly blinked: the GoB placed USD 600 million in Eurobonds on June 20 at lower interest rates than it had been able to obtain in a February 2005 offering and the Real has resumed its pre-scandal appreciation against the dollar. The GoB also is trying to shift the public's focus by proposing a dramatic tightening of fiscal policy, which it hopes would create space for large reductions in Brazil's unpopular high interest rates. The political scandal, however, makes it extremely unlikely that the GoB will be able to obtain passage of these fiscal measures, a critical piece of which must be approved by a three-fifths majority of Congress. The GoB's broader microeconomic reform agenda (ref B) is in similarly difficult straits. Without significant reforms, however, expect GDP growth in the election year of 2006 to be only marginally better than the modest growth expected this year (2.5% to 3.0%). End Summary.

Central Bank President a Lame Duck

¶2. (SBU) Along with the downfall of President Lula's powerful chief of staff Jose Dirceu, the vote-buying scandal (ref C) looks likely to hasten the departure of Central Bank President Henrique Meirelles. Meirelles is under investigation by the Supreme Court on charges, unrelated to the scandal, i.e., that he evaded taxes, engaged in illegal money transfers and violated electoral laws in his 2002 Congressional campaign (ref D). While Meirelles long had been planning to leave the Central Bank by end-August to prepare his planned run for governor of Goias state in 2006, the vote-buying scandal has made his tenure at the Central Bank less tenable. The leading candidate to replace Meirelles, Vice Finance Minister Murilo Portugal, who was Brazil's Executive Director at the IMF until April, has a sterling reputation as a fiscal and monetary conservative and would likely maintain Bank policies along the lines set by Meirelles and his team.

¶3. (U) Accordingly, financial markets have been taking the political scandal in stride. After an initial wobble, the Real has resumed its trend of appreciation against the dollar (ref A), and is close to its three-year high against the dollar. On June 20, the GoB placed a $600 million ten-year Eurobond at a spread of a mere 363 basis points over U.S. treasuries. By comparison, the yield on this bond offering, 7.73%, was down from the 7.9% yield on Brazil's February $1 billion offer, although the spread over U.S. treasuries on that offer was 10 basis points lower.

Pork over Payola

¶4. (SBU) The GoB moved quickly after the scandal broke to try to shore up its support with industry by speeding up the issuance of a Provisional Measure (MP), previously under consideration, which creates a grab-bag of goodies for several sectors. (Note: MPs are a form of executive decree with immediate force of law, but which nevertheless require congressional ratification to become permanent legislation.) MP 252, issued by Lula on June 15, enacts a series of changes in the tax system to benefit multiple sectors. The

"Recap" tax regime would suspend certain taxes on the sales and importation of capital goods for firms of which 80 percent or more of revenues are export-related, while the "Repes" provides specific exemptions for software and IT exporters. The MP also makes more flexible a tax credit regime applicable to capital investments. Some Brazilian analysts have questioned the WTO-consistency of the tax benefits for exporters; see septel for an unofficial translation of the relevant provisions.

¶5. (SBU) MP 252 also enacts tax measures to help the construction industry, including an income tax exemption on the capital gains on the sale of a home if the seller buys a new home of equal or greater value within 180 days. In conjunction with several related MPs, MP 252 also seeks to create incentives for innovation by doubling tax deductions on the amount a firm spends for research and development. While Congress has not yet acted on MP 252, given the popularity of tax cuts the measure, in some form, is likely to be approved.

¶6. (SBU) The Finance Ministry has estimated the cost of MP 252, in foregone revenues, at 1.5 billion Reals this year (approximately $625 million) and 3.3 billion Reals ($1.3 billion) next year. Despite the measure's cost, there is little risk that the GoB will not meet its primary surplus target. Revenues continue to grow faster than GDP and the GoB retains discretion not to spend amounts authorized in the budget. Moreover, IMF Resident Representative Max Alier and UN economist Carlos Mussi emphasized to Econoff that, even if it wanted to, the GoB would find it hard to try to "buy" its way out of the scandal. Fiscal Responsibility Law (LRF) provisions requiring that new spending be matched with a funding source are not easily bypassed, Alier argued. Mussi observed that, to avoid even the hint of impropriety, the knee jerk response of Lula's orthodox-minded economic team to a political crisis will be to trend even more conservative on spending decisions. Others within the GoB have made much the same point; i.e. with macroeconomic stabilization and the resumption of economic growth representing the principal achievement to date of the Lula administration, the president is loathe to tinker with his orthodox macroeconomic policies.

Fiscal Policy to Attack Interest Rates

¶7. (SBU) To reaffirm its credentials with the market -- and attack a principal cause of roundly unpopular high interest rates -- the GoB is debating a relatively bold series of fiscal measures to tighten fiscal policy. Principal among these is moving, over the course of four to five years, from targeting a primary surplus to an overall balanced budget (nominal deficit of zero). The idea, which has some traction with fiscally conservative elements in Congress, is to create space for dramatic interest rate reductions in the medium term by significantly reducing the GoB's borrowing requirements. This would reduce crowding out of credit to the private sector and allow interest rates to fall. (Note: Many other factors also influence Brazil's infamously high real interest rates -- see ref E.) The plan's proponents (among them Federal Deputy and former Finance Minister Delfim Netto) argue that falling interest rates would have a "virtuous circle" effect, and by reducing GoB interest costs, further reduce the borrowing requirement.

¶8. (SBU) For the plan to work, the GoB would require greater flexibility in prioritizing expenditures and the ability to use a greater proportion of revenues for debt service. Currently, the vast majority of GoB revenues are subject to constitutional earmarks and revenue sharing requirements with state and municipal governments. The GoB would have to obtain Congressional support for a constitutional amendment enlarging the current de-earmarking measure (or DRU, in its Portuguese acronym) from 10% of overall federal revenues to 20% or 30% of revenues. Moreover, not all of the mooted measures have GoB-wide support. While supporting a move towards a nominal fiscal balance, the Finance Ministry has pointed out that a strict target would require volatile primary expenditure patterns if the GoB had to act to offset sudden interest rate and exchange rate shifts. For similar reasons, in a conversation with Econoff, the IMF's Alier also questioned the wisdom of a firm nominal balance target. The overall idea of using greater fiscal restraint and expenditure flexibility to create room to reduce interest rates, however, has found a sympathetic audience among politicians and businessmen weary of sky-scraping interest rates.

Comment

¶9. (SBU) A significant part of the GoB's response to the political vote-buying scandal has focused on economic policy, which is at best a secondary tool in dealing with the problem. Nevertheless, it is to the GoB's credit that

its proposed reforms to attack (unpopular) high interest rates are grounded in orthodox economics. Moreover, its pork-barrel MP will not vitiate its ability to meet its primary surplus targets. But, with a poisoned congressional atmosphere, it is difficult to see the GoB obtaining passage of any significant legislation to tighten fiscal policy, much less getting the three-fifths majority necessary to modify constitutional earmarking requirements. In addition, Lula's microeconomic reform agenda (ref B) looks dead, with the exception of measures that do not require congressional action, such as implementation of already-approved public-private partnerships (PPPs). Without significant reforms, however, GDP growth next year should not be much better than this year's expected 2.5% to 3.0%. All of this must weigh heavily on the mind of a reelection-minded President, who, absent some unexpectedly deft political management, is in danger of becoming seriously politically weakened with more than a year to go before the 2006 elections.

DANILOVICH